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Wheaton, Illinois

July 1, 2015

Via email at rule-comments@sec.gov

Mr. Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

File # *S7-07-15 (Proposed* Rules *on Pay* vs. *Performance)*
Release No. 34-74835

Dear Sir:

We offer the following in our commentary in response to the Securities and Exchange Commission's (SEC) request for comments *in re* the proposed amendments to Item 402 of Regulation S-K, those changes adding Section 14(i) to the Securities Exchange Act of 1934, regarding *Pay for Performance* (PfP) regulations as they relate to Publicly-Traded Corporations (PTC).

Pay for Performance *Housekeeping*

There is no more important resource to PTCs than key executive personnel and more specifically the *named executive officers* (NEOs) of same. Although much has been said recently about excessive executive compensation, the truth is that base compensation for CEO's has held at a range of $750,000 to $1.5MM for some time. The compensation *troika* of *attract, motivate* and *retain* has been a guiding principle in compensation circles for decades. There has been an effort by PTCs to keep as much compensation to NEOs *at risk* as possible, which may now be part of the reason for the substantial number of *earnings restatements*[1] over the last decade or so. To the troika must now be added a fourth leg of the stool and that is to *verify,* thus the appearance on the scene recently of the need for application of clawback/recoupment of compensation paid in the event of executive malfeasance.

In an attempt to manage *and report publicly* the compensation paid to key executive personnel, companies follow procedures laid out for them by various

1 **See Center for Audit Quality (CAQ), *Financial Restatement Trends in the United States: 2003–2012.***

governmental entities. Because of the intricacies of such reporting, it would not be uncommon to become aware of incongruities that have developed in such reporting. One such example is found in our commentary to the SEC, on an as yet unreported issue related to *anti-hedging* restrictions shown at http://www.sec.gov/comments/s7-01-15/s70115-1.pdf. Similarly, *this* commentary presents additional unreported issues related to *basic* aspects of executive compensation that should be considered in any discussion on PfP for key executive personnel. We believe that there is a need for a resolution of a *paradigm congestion* that has beset the practice and governance of executive compensation and its many disciplines, i.e., tax, regulatory, investment, financial reporting, valuation, etc. We believe such a resolution could be a simple one.

Begin at the Beginning

In March of 2005, we commented on employee stock options (ESOs) incorrect taxation to the President's Advisory Panel on Tax Reform, shown at **http://govinfo.library.unt.edu/taxreformpanel/comments/_files/030805WingTimothy.pdf**. The chronology of ESO exercise date taxation began when the Internal Revenue Service (IRS or Service), made an assumption that ESOs could not be valued and taxed upon their grant, relying instead on their concept of a *bargain purchase*[2] in taxation, to extrapolate its usage to the taxation of ESOs upon their exercise. With the recent ruling by the Supreme Court in re the *Affordable Care Act*[3], we are reminded that the ***intent*** of Congress, on the grant-based taxation of ESOs, as suggested in our comments to the Tax Reform Panel above, may now have current significance.

This is in juxtaposition to the Financial Accounting Standards Board's (FASB) protocol for the *grant-based* valuation of ESOs for financial reporting purposes in 1995, i.e., Statement of Financial Accounting Standards No. 123 (SFAS 123), now ASC (Accounting Standards Codification) 718; and the SEC's May 1, 1991 changes to the Securities Act of 1934, eliminating ESO exercise as a *matchable* event for insider-trading purposes and focusing instead on ESO *grant.* The three examples to follow present tax-based paradigms, that the IRS relies upon, that are directly related to SFAS 123 and the grant-based ESO valuation methodology established by same.

2 ***Bargain purchases.*** A bargain purchase is a purchase of an item for less than its FMV. If, as compensation for services, you buy goods or other property at less than FMV, include the difference between the purchase price and the property's FMV in your income. Your basis in the property is its FMV (your purchase price plus the amount you include in income). See IRS Publication 17

3 ***KING ET AL. v. BURWELL, SECRETARY OF HEALTH AND HUMAN SERVICES, ET AL. CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT No. 14–114. Argued March 4, 2015—Decided June 25, 2015***

1. Revenue Procedure 98-34 (Rev Proc 98-34) issued in April of 1998, states, in part: "Section 1. PURPOSE – This revenue procedure sets forth a methodology to value for gift, estate and generation skipping transfer tax (transfer tax) purposes certain compensatory stock options described in Section 3 of this revenue procedure. Taxpayers relying on this revenue procedure may use an option pricing model that takes into account on the valuation date specific factors that are similar to those established by the Financial Accounting Standards Board in Accounting for Stock-Based Compensation, Statement of Financial Accounting Standards No. 123, (Fin. Accounting Standards Bd. 1995), (FAS 123)."

2. Revenue Procedure 2002-13 (Rev Proc 2002-13), states, in part: "SECTION 1. PURPOSE – This revenue provides guidance for valuing stock options stock options, including a safe harbor for valuing compensatory stock options for purposes of §§ 280G [parachute payments] and 4999 of the Internal Revenue Code (IRC)… SECTION 3. STOCK OPTION VALUATION .01 In general, a taxpayer may value a compensatory stock option using any valuation method that is consistent with generally accepted accounting principles (such as FAS 123)…."

3. Proposed Regulations 1.482 [Transfer Pricing – Cost Sharing Arrangements, states, in part: "Under the proposed regulations stock-based compensation must be taken into account for the purpose of determining operating expenses subject to a QCSA [qualified cost sharing arrangement] …. The proposed regulations provide two methods of determining the compensation related to stock-based compensation: the exercise-date and grant-date methods. The exercise-date method is the regular method; the grant-date method is elective for companies whose stock is publicly traded…. *Grant-date method.* ….Under this method, each time an option is granted the valuation model must be applied to determine the resulting compensation. Compensation is equal to the fair value of the stock options reflected as a charge against income in audited financial statements, or disclosed in footnotes to financial statements prepared in accordance with U.S. GAAP.

What we are suggesting then is that even though the IRS eschews ESO grant-based taxation for individual income tax purposes, it relies upon the grant-based valuation protocol of SFAS 123 for at least three separate tax protocols. Why is all of this important in the discussion of *PfP?*

Interim Recap 1

> *The current exercise-date tax treatment of ESOs is a thumb-on-the-scale approach to the measurement of PfP. It ignores the wealth-effect of a multi-year appreciation in the underlying employer common stock that is aggregated and taxed in just one year, thereby potentially skewing any calculated ratio. Were ESOs taxed upon their grant, significantly less income would be taxed in an identifiable grant year, with no other reportable income taxable to the key executive save that amount taxable as capital gain or loss upon the ultimate disposition of the underlying employer common stock, which would not be an issue in financial reporting or corporate governance. ESO exercise would not be a taxable event and would be a reportable event only, for insider trading purposes.* ***This issue has added importance in light of the FASB's proposed Accounting Standards Update (ASU) for ASC 718 entitled "Improvements to Employee Share-Based Payment Accounting."***

We then have an *incongruity* between the *book* [financial reporting]/tax treatment of ESOs which is laid bare in the financial statements of PTCs, ameliorated only by the arcane nature of the issue. But we also have a second incongruity, which can be a bit more troubling, that emanates from the incentive compensation practices of PTCs.

PTCs, in the *Compensation, Discussion and Analysis* (CDA) found in their *Annual Proxy Statements* (APS), highlight the *grant-date fair value* (GDFV) of ESOs upon their grant, even though these amounts are not included in the actual income of NEOs. Why bother to report it then? Because it is something of value and that value is shown usually in both the *Summary Compensation Table* (SCT) and the *Grants of Plan-Based Awards Table* (GPBAT). PTCs are making a statement that their NEOs are receiving something of value. **To take the reader now in a different direction, a new issue revolves around the incentive governance practice of an equity incentive award value being expressed in absolute *dollar* terms. This requires a closer look at the SFAS 123 valuation protocol.**

The SFAS 123 valuation protocol (123VP) is designed to value ESOs that are financial instruments that **DO NOT** trade freely on a securities exchange. This is accomplished with a theoretical option model, usually the *Black-Scholes Model* (BSM) that is designed to value financial instruments that **DO** trade freely on such exchanges. There would appear to be a valuation *mismatch* resulting in an ESO *overvaluation*. **This means that, in general, the GDFVs that are being presented in the APS, overstate the values that are being attributed to the NEOs by possibly as much as 100%.**

Realizing that some adjustment would need to be made to the BSM value, the FASB allowed some flexibility in the BSM calculation inputs used by PTCs in their 123VP, most notably in the selection of the *term* of the ESO being granted, suggesting that this was somehow a tradeoff for what normally would be applied to an illiquid security, i.e., a lack of marketability (LOM) discount applied to the calculated BSM ESO value. Any PTC is allowed to substitute the expected life (EL) of the ESO being granted, i.e., a lower BSM input value, and then also a lower final BSM ESO value calculated.

The FASB has concluded that the use of EL in calculating option values……

> …rather than its maximum term is a logical and practical means of reducing the option's value to reflect its marketability. [para 170, SFAS 123]

The FASB supposedly based its decision to use EL on…..

> …. papers presented by academic researchers [who] generally agreed that use of expected life is the appropriate way to adjust for the nontransferability of employee stock options. [para 172, SFAS 123]

The FASB's reliance on the use of EL in calculating option values to adjust ESO values to freely-traded values is incorrect because it understates the effect of ESO restrictions. Exhibit I includes two matrices which track ESO values by using ten separate BSM calculations by incrementally increasing the term of the ESO i.e., a BSM calculation with a one year term, a BSM calculation with all the same assumptions but with a two year term, three year term…. ten year term. The two matrices reflect two different types of companies. Company A's stock price has 20% volatility and the Company pays a 2% dividend. Company B's stock price has 100% volatility and pays no dividends.

The summary at the bottom of Exhibit I compares [for both Company A and B] the ten-year BSM values to both the six year and seven year BSM values, in an attempt to show the diminution in value for the use of EL. In doing so, one can see that such diminution has far less an effect than suggested by the FASB and that such diminution has less effect as the type of company changes from low volatility with dividend to high volatility with no dividend i.e., most startup companies who might use ESOs in their compensation mix.

As the Exhibit I Summary shows, for Company B, a high tech type company, the decline in BSM values from the YR 10 values to the YR 6 or YR 7 values was only about 10%, hardly a significant enough discount to represent the kinds of marketability restrictions attendant to ESOs. ESOs should be considered securities with restrictions attached thereto that have an effect on value. The IRS, in their Revenue Ruling 77-287[4], established that such restrictions, primarily lack of marketability, would have an effect on such value.

The Perception of *Self-Dealing*

The valuation protocol established by ASC 718 and prior pronouncements allows for considerable variability in the inputs to a *theoretical* option model, thereby producing a potential *range* of values but more importantly a value that is at the discretion of the key executives whose compensation *may be* determined, in part, by such calculation. This discussion considers a similar situation in the financial reporting of executive compensation that may provide some additional insight on potential *self-dealing* by NEOs.

ESO Valuation Overstatement

Stock-based compensation programs secure considerable cash benefits for the employer corporation, i.e., operating cash flows, in using the employee option holder as a *conduit* via a process that we refer to as the ESO *Cycle*. ESOs are granted with the value at grant *currently*[5] reconciled with the actual tax expense upon exercise, with as much of the original grant date value assigned to operating cash flows rather than financing cash flows as additional paid-in capital. There is, however, considerable academic research that suggests potential problem areas where operating cash flows are present as a performance metric in executive compensation agreements with key executive personnel. As the exercise reconciliation amount is unknown until ESO exercise, the emphasis would tend towards higher ESO values upon their grant.

ESO Valuation Understatement

Where ESO grants are made in concert with other forms of equity grants, a like *dollar* amount of ESO grants is often made in tandem, which suggests that a lower GDFV would cause the NEO employee, to receive added *absolute* amounts of ESO

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4 ***1977-2 C. B.. 319***

5 **See FASB Accounting Standards Update entitled, *Improvements to Employee Share-Based Payments Accounting***

grants. There could then be a direct effect on the proxy disclosure of the various compensation and benefits values attributed to each of the NEOs.

Interim Recap 1I

> *The ESO Cycle is completed and begins again as cash flows assist in the financing of open market common stock repurchases to fund further ESO grants. Along the way, the 123VP, by its allowance for flexibility in option model input assumptions from year to year, allows for similar flexibility in earnings management. These amounts may seem immaterial but when one considers 3-4 year vesting periods the aggregation of ESO compensation expense can have a material effect during a particular earnings cycle. For purposes of PfP, we focus on ESO Valuation Understatement to focus on an important incongruity and that is* ***self-dealing*** *or the* ***perception*** *of same by NEOs.*

We draw upon the 2014 financial statements of an actual but unnamed PTC (UPTC) to provide an example of a *possible* occurrence of this issue, which involves potential *self-dealing* on the part of NEOs, ***although we stipulate that we have no evidence of any such self-dealing by this anonymous PTC.***

The UPTC Board of Directors (BOD) compensates their NEOs in a variety of ways but primarily with cash, stock and ESOs. The UPTC APS discusses compensation paid/granted to their NEOs for the prior year and more specifically, one individual, NEO#1, who during 2014 has been awarded 29,050 ESOs granted at an exercise price of $63.45, which was the fair market value (FMV) of UPTC common stock on the day of such ESO grant.

So, the issue now is how UPTC arrived at the 29,050 ESOs that were granted to NEO#1? Under UPTCs' *Executive Incentive Plan,* whatever the equity award value granted to NEOs, including NEO#1, 75% of that award is in the form of ESOs and 25% is in the form of restricted stock. We see from the UPTC APS SCT that our NEO#1 received an ESO award in 2014 that was valued at $212,148, but we have not been apprised as to how the UPTC arrived at the grant amount of 29,050 ESOs.

In the above discussion, the amount "29,050" stands out as a *calculated* value rather than as a *rounded* value, suggesting that it was the value produced, possibly, where a *dollar*-amount award value was divided by a GDFV of the UPTC ESO awarded. Simple math suggests that as the *divisor* decreases in value, with the numerator or *dividend* remaining the same, then the result or *quotient* of the equation will *increase*.

In reviewing UPTC's prior year [2013] Form 10-K/Proxy, we determined using an independent BSM calculation, that UPTC has **undervalued** ESOs for financial reporting purposes. Specifically, the weighted average GDFV for the 2011 - 2013 UPTC ESO grants are shown below compared to the independent calculations:

	2013	2012	2011
UPTC [WAGDFV]	$ 9.55 [-14.4%]	$ 9.48 [-6.3%]	$ 8.04 [-19.4%]
Independent Calculation	$11.15	$10.12	$ 9.98

The above understated UPTC ESO values lessen overall reported expenses, increasing income by a similar amount. More specifically, the effect on compensation expense over the vesting period of the above three ESO grants is as follows for the years indicated:

	2014	2015	2016	2017	2018
ESO Expense Under-Statement	**$1,258,313**	**$1,592,780**	**$2,477,579**	**$1,300,000***	**$1,000,000***

***approximations**

The aggregate ESO expense understatement is approximately $7,628,672 for the three UPTC ESO grants 2011-2013 as shown above. Although this amount could be considered *de minimis* and possibly not material for financial reporting purposes, it could not be considered so from a compensatory standpoint, as possibly millions of dollars of added UPTC ESO grants [shares] could have been made to NEOs under the above protocol.
Our recommendation then is that there should certainly be added disclosure on the calculation itself of the ESO award value and its relationship to the ESO WAGDFV in the above context, in what I would refer to as a *calculation chain*, tagged to text, e.g., the 29,050 amount shown above.

Summary

1. ESOs should be taxed upon their grant for both book and tax purposes. This is not a new idea as Senator Levin has proposed such legislation.[6]

6 S. 2075 (*Ending Excessive Corporate Deductions for Stock Options Act*)

2. Where there is a mathematical calculation, i.e., 123VP, that ties an NEO incentive award to such calculation, where such calculation is also controlled by the award recipient such perception of self-dealing should be acknowledged.
3. The 123VP, now part of ASC 718, should be modified in keeping with the above discussion on restricted securities, to properly adjust "pay" in consideration of the PfP initiative.

Yours very truly,
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EXHIBIT I
Company A – 20% Volatility, 2% Dividend

BSM INPUT VARIABLES	YR1	YR2	YR3	YR4	YR5	YR6	YR7	YR8	YR9	YR10
STK PX	$100	$100	$100	$100	$100	$100	$100	$100	$100	$100
EX PX	$100	$100	$100	$100	$100	$100	$100	$100	$100	$100
TERM	1.00	2.00	3.00	4.00	5.00	6.00	7.00	8.00	9.00	10.00
VOLATILITY	20%	20%	20%	20%	20%	20%	20%	20%	20%	20%
ANNL RATE QTRLY DIV	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
INT RATE	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.80%	3.90%	4.00%
INTER COMPUTATION										
PV OF STK EX-DIV	$98.02	$96.0	$94.1	$92.33	$90.51	$88.72	$86.97	$85.25	$83.56	$81.91
PV OF EX PX	$97.07	$94.0	$90.9	$87.73	$84.49	$81.21	$77.90	$74.00	$70.64	$67.30
CUM VOLATILITY	20%	28%	35%	40%	45%	49%	53%	57%	60%	63%
CALL OPTION										
PROP OF STK PV	55.93%	58.6%	60.8%	62.8%	64.7%	66.4%	68.1%	70.3%	71.9%	73.4%
PROP OF EX PX PV	-47.97%	-47%	-47%	-47.1%	-47.2%	-47.4%	-47.7%	-48.7%	-49.2%	-49.7%
BSM CALL OPT VAL	$8.26	$11.7	$14.4	$16.69	$18.67	$20.46	$22.10	$23.89	$25.33	$26.68

Company B – 100% Volatility, 0% Dividend

BSM INPUT VARIABLES	YR1	YR2	YR3	YR4	YR5	YR6	YR7	YR8	YR9	YR10
STK PX	$100	$100	$100	$100	$100	$100	$100	$100	$100	$100
EX PX	$100	$100	$100	$100	$100	$100	$100	$100	$100	$100
TERM	1.00	2.00	3.00	4.00	5.00	6.00	7.00	8.00	9.00	10.00
VOLATILITY	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
ANNL RATE QTRLY DIV	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%
INT RATE	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.80%	3.90%	4.00%
INTER COMPUTATION										
PV OF STK EX-DIV	$99.99	$99.98	$99.97	$99.96	$99.95	$99.94	$99.93	$99.92	$99.91	$99.90
PV OF EX PX	$97.07	$94.03	$90.92	$87.73	$84.49	$81.21	$77.90	$74.00	$70.64	$67.30
CUM VOLATILITY	100%	141%	173%	200%	224%	245%	265%	283%	300%	316%
CALL OPTION										
PROP OF STK PV	70.18%	77.35%	82.14%	85.66%	88.36%	90.48%	92.18%	93.58%	94.69%	95.60%
PROP OF EX PX PV	-31.9%	-25.3%	-20.8%	-17.5%	-14.8%	-12.7%	-10.9%	-9.5%	-8.3%	-7.2%
BSM CALL OPTION VAL	$39.21	$53.51	$63.15	$70.28	$75.77	$80.10	$83.57	$86.44	$88.73	$90.61

EX I SUMMARY - % DECLINE FROM YR 10 BSM VALUES

	<u>YR 6</u>	<u>YR 7</u>	<u>YR 10</u>
Company A	$20.46 / [23%]	$22.10 / [17%]	$26.68
Company B	$80.10 / [12%]	$83.57 / [8%]	$90.61